

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

FEB - 7 1994

Key District Office: Cincinnati

EIN: [REDACTED]

NO PROTEST RECEIVED  
No less copies to District

Date 11/21/95

Signature [REDACTED]

Dear Applicant:

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We have completed our consideration of your application for recognition of exemption from federal income tax. We have concluded that you are not exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code. The reasons for our conclusions are explained below.

You were incorporated on [REDACTED], as a nonprofit corporation under the law of [REDACTED]. You filed your application for recognition of exemption with the Service on [REDACTED]. You request recognition of exemption prospectively from the date you file the application. Your purposes, according to the amended articles of incorporation, are the following: 1) to establish and maintain a psychiatric hospital for the care and treatment of the sick, 2) to conduct educational activities concerning care and treatment of the sick and 3) to operate exclusively for charitable and educational purposes within the meaning of section 501(c)(3) of the Code.

To achieve these purposes, you operate a [REDACTED] bed psychiatric hospital located near [REDACTED]. The hospital offers inpatient and outpatient psychiatric care to the surrounding community. The health services you provide include general psychiatry, care for stress and depression, panic and anxiety, eating disorder, alcoholism and chemical dependency.

Your financial support comes from fees charged for the above services. Your patients are admitted based upon their ability to pay from their personal sources, insurance companies or Medicare. You do not accept Medicaid. However, you do provide financial aid to those who are unable to afford your medical services. The amount of the financial aid is based upon a sliding scale.

[REDACTED]

You are governed by a [REDACTED] member board of trustees. They and your officers are compensated for their work. From [REDACTED] to [REDACTED], the trustees were paid approximately \$[REDACTED] per year. Two of your trustees, [REDACTED] and [REDACTED], also provide services to you in connection with your activities; the latter serves as a part-time medical director, and the former provides consulting services.

Four members of your trustees, [REDACTED], [REDACTED], [REDACTED], and [REDACTED], controls, as shareholders, a for-profit company, [REDACTED] (hereinafter [REDACTED]), which owns your hospital facility.

In a letter dated [REDACTED], you made reference to an audit of the hospital for the years [REDACTED] to [REDACTED] and stated that a copy of the audit had been forwarded to us as supplement to the information in your application and file. The information in the file indicates that you are leasing the hospital facility from [REDACTED]. For the years [REDACTED] to [REDACTED], you reported rent expense for [REDACTED] to [REDACTED] as \$[REDACTED], \$[REDACTED], and \$[REDACTED], respectively. The amounts were substantially reduced by the audit. In [REDACTED], you had an appraisal made of the property and facility to determine the fair rental value of the property. The appraiser, in a report dated [REDACTED], determined that the fair rental value is \$[REDACTED] per annum of a net lease.

Thereafter, you entered into a net lease that was effective beginning [REDACTED] for the rental of the hospital facility from [REDACTED]. The lease was for one year with an option to extend this lease for two periods of one year each. Under the lease, you were required to pay rent in the amount of \$[REDACTED] per annum. You were also required to pay all taxes, utilities, maintenance, taxes and insurance for the hospital facility.

You change the terms of this lease in an amended lease that was effective beginning [REDACTED]. The terms in this amended lease is similar to the [REDACTED] lease except that the amount of the rent was \$[REDACTED].

You have negotiated a new one year net lease that is effective beginning [REDACTED]. The terms are nearly the same as the [REDACTED] lease except that the rent is in the amount \$[REDACTED], an increase of \$[REDACTED] over the amount in appraisal report. You have an option to extend the lease for two periods of one year each with the rent determined by the consumer price index with the amount of \$[REDACTED] as the base rent.

The information in the file indicates that in [REDACTED], you established a clinic located in [REDACTED] for the purpose of providing psychiatric care to the community. Also in [REDACTED],

██████████ trustees, ██████████, ██████████, and ██████████ formed a for-profit corporation known as ██████████ (hereinafter ██████████). Because ██████████ needed working capital, you provided a loan of \$██████████ at prime interest rate and a line of credit of approximately \$██████████ to ██████████. An additional loan of \$██████████ was made to ██████████ in ██████████. Once capitalized ██████████ assumed the operation of your clinic, but you receive no compensation. You hired ██████████ as your collection agency for delinquent accounts. ██████████ received a ██████████ percent commission on amounts collected from those accounts.

At the end of ██████████, ██████████ was liquidated by its shareholder, and the assets and debt accumulated from the operation of the clinic were transferred over to you. ██████████ had assets of approximately \$██████████ and debt of approximately \$██████████ which was owed to you at the time of liquidation. After reassuming the operation of the clinic, you declared the \$██████████, the difference between ██████████' assets and debt, as bad debt and deducted from your income tax.

Section 501(a) of the Code exempts from taxation organizations described in section 501(c).

Section 501(c)(3) of the Code provides for the exemption from federal income taxation of corporations organized and operated exclusively for charitable and educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that, in order to be exempt as an organization described in section 501(c)(3) of the Code, an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. Failure to meet either the organizational or operational test will disqualify an organization from exemption under section 501(c)(3).

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more exempt purposes specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the regulations provides, in pertinent part, that an organization will not satisfy the operational test if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Under section 1.501(a)-1(c) of the regulations, the term "private

shareholders or individuals" refers to persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides, in pertinent part, that an organization is not organized or operated exclusively for a section 501(c)(3) exempt purpose unless it serves a public rather than a private interest. Thus, it is necessary that the organization establish that it is not operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Section 1.501(c)(3)-1(d)(2) of the regulations provides in pertinent part, that the term "charitable" is used in section 501(c)(3) of the Code in its generally accepted legal sense.

Rev. Rul. 69-545, 1969-2 C.B. 117 describes two hospitals which has requested recognition of exemption under section 501(c)(3) of the Code. Hospital A is a 250-bed community hospital. Its board of trustees is composed of prominent citizens in the community. Medical staff privileges in the hospital are available to all qualified physicians in the area. The hospital ordinarily limits admissions to those who can pay the cost of their hospitalization, either themselves, or through private health insurance, or with the aid of private health insurance, or with the aid of public programs such as Medicare. Patients who cannot meet the financial requirements for admission are ordinarily referred to another hospital in the community that does serve indigent patients. Profit from services provided are generally applied to expansion and replacement of existing facilities and equipment, improvement in patient care, and medical training, education, and research. Hospital B was originally owned by five doctors. The owners formed a nonprofit organization and sold their interests in the hospital to the organization at fair market value. The board of trustees of the organization consists of the five doctors, their accountant, and their lawyer. Hospital admission is limited to those who can pay the cost of services rendered. The Service holds that Hospital A is organized and operated for a charitable purposes due to several factors. First, Hospital A is promoting the health of a class of persons that is broad enough to benefit the community. Second profit derived from services provided are used to improve the quality of patient care, expand its facilities, and advance its medical training, education, and research programs. Finally it is operated to serve a public rather than a private interest. However, the Service holds that Hospital B is not organized and operated for a charitable purpose because it is operated for the benefit of its doctors who exercise control over the hospital through the board of trustees.

Rev. Rul. 67-5, 1967-1 C.B. 123 describes a foundation controlled by the creator's family. The foundation was operated to enable the creator and his family to engage in financial activities that were beneficial to them, but detrimental to the foundation. This resulted in the foundation's ownership of non-income producing assets which prevented its carrying on a charitable program commensurate in scope with its financial resources. The ruling concludes that the foundation was operated for a substantial non-exempt purpose and served the private interest of the creator and his family. Therefore, the Service holds that the foundation was not entitled to exemption under section 501(c)(3) of the Code.

In Better Business Bureau v. United States, 316 U.S. 279 (1945), the Supreme Court holds that the existence of a single non-exempt purpose, if substantial in nature, will destroy the exemption under section 501(c)(3) of the Code. An organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such purposes.

In Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974), the court holds that an organization seeking a ruling as to recognition of its tax exempt status has the burden of proving that it satisfies the requirements of the particular exemption statute. Whether an organization has satisfied the operational test is a question of fact.

Based on the information submitted, we have concluded that you are not organized and operated in furtherance of charitable, scientific, or educational purposes within the meaning of section 501(c)(3) of the Code due to the following reasons. First, you fail to show that the operation of your hospital confers sufficient benefit to your community as a whole. In Rev. Rul. 69-545, supra, the Service states that a charitable hospital meets a community's needs, and thus qualify for exemption, if it meets numbers of factors. These factors include admission of patients without regard to ability to pay or accept public aid through Medicare, Medicaid or other governmental aid program, a board of directors drawn from the community, providing medical training, education and research, etc. The information in the administrative file indicates that none of these factors are present in your situation. You do not have a board of trustees that is comprised of independent civic leaders; you do not conduct medical training, education, or research; you do not accept Medicaid or other state or federal governmental assistance programs for indigents. Although you do accept Medicare and provide financial assistance to those who cannot afford the price of your care, the class of beneficiaries of those two programs is

limited. Medicare are only available to seniors, and those seniors are not necessarily indigents. Therefore, the class of charitable beneficiaries that benefits from your activities is so small that relief is not of benefit to the community as a whole.

Second, you have been and are operated to benefit the private interests of members of your board of trustees. This contravenes the requirement of section 1.501(c)(3)-1(c)(2) and section 1.501(c)(3)-1(d)(1)(ii) of the regulations, and Rev. Rul. 67-5, supra, that a section 501(c)(3) organization be operated primarily to further a public, rather than a private interest.

The information in the administrative file clearly indicates that there was a pattern of transactions that inured to the benefit and served the private interests of your trustees. For example, when [REDACTED], which was controlled by your trustees, assumed the operation of your clinic, you were not compensated. In fact, you even provided loans and a line of credit to [REDACTED], regardless of the financial worthiness and soundness of [REDACTED], so as to ensure that it had sufficient capital to operate the clinic. Furthermore, you hired [REDACTED] as your collection agency so as to provide income to [REDACTED].

When the operation of the clinic became unprofitable and was in debt, you reassumed the operation of the clinic so as to relieve [REDACTED] of this unprofitable venture. In fact, you reassumed a clinic whose liability was greater than the assets. As a result, you had to declare a portion of the liability as bad debt. You made no attempt to collect the bad debt from [REDACTED] or its shareholders.

Additional examples of private benefit and inurement to your trustees are the rent payments you made to [REDACTED] and the salaries you provide to your officers and trustees. [REDACTED] is controlled and owned by [REDACTED] of your trustees. For the years [REDACTED] to [REDACTED], there was no indication that the rent you paid to [REDACTED] was determined at fair market value. There also was no indication that the rent in the [REDACTED], [REDACTED] and [REDACTED] leases were based upon fair market value. In fact, the amount of rent agreed in those three leases was above the amount recommended in the [REDACTED] appraisal report. Even if the rent was based upon the appraisal report, an appraisal is not determinative of the fair rental value of a property when there is a common control between the lessor and lessee. Furthermore there is no evidence to show that the other requirements, payment of insurance, utilities, taxes, etc. of the hospital facility, in the [REDACTED], [REDACTED] and [REDACTED] leases are the standard requirements in leases of similar organizations. Consequently, there is no evidence to show that the terms of the leases were not design to serve the economic interest of your trustees and [REDACTED].

[REDACTED]

Finally, there is no evidence to show that the compensation received by your trustees and officers has been negotiated at arms-length, and is the standard for like organizations in your line of activities and in comparable circumstances. Furthermore, the amount received has not been shown to be reasonable in terms of the responsibilities and duties assumed. Thus, you have failed to demonstrate that you are not operating for the private benefit of your trustees.

Therefore, you are not organized and operated for charitable purposes within the meaning of section 501(c)(3) of the Code. Accordingly, we conclude that you do not qualify for exemption from federal income taxation under that subsection of the Code. Thus, you are required to file federal income tax returns for all periods since your incorporation.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this proposed ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgment or decree under this section shall not be issued in any proceeding unless the United States Tax Court, the United States Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and copies will be forwarded to your key District Director. Thereafter, any questions about your federal income tax status should be addressed to that office. The appropriate State Officials will be notified of this action in accordance with section 6104(c) of the Code.

When submitting additional letters with respect to this case to the Internal Revenue Service, you will expedite their receipt by placing the following symbols of the envelope: [REDACTED]

[REDACTED]  
Room [REDACTED]. These symbols do not refer to your case but rather to its location.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely yours,

[REDACTED]  
[REDACTED]  
Chief, Exempt Organization  
Rulings Branch

cc: DD, Cincinnati  
Attn: EO Group

cc: State Officials of [REDACTED]

cc: [REDACTED]  
[REDACTED]  
[REDACTED]

2/4/94

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